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Subcommittee on Courts, Intellectual Property, and the Internet
Hearing on First Sale Under Title 17
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Introduction

Chairman Coble, Ranking Member Nadler, and members of the Subcommittee, thank you for the opportunity to participate in today's hearing on the impact of changing the first-sale doctrine to apply to electronically-delivered content. I testify today in my personal capacity as someone who has spent more than two decades working within content companies (in music, film and television) designing products and distribution models that are responsive to advances in available technology and changes in consumer demand.

It is essential for Hollywood (and other content industries) to be agile in growing new business models. This innovation must be done thoughtfully, accounting for the substantial amounts that creators invest each time they produce a new film or television show, and that is precisely what the movie and television industry has been doing. The high speed of technological advancement in content businesses over the past 15 years is obvious. Today's digital marketplace offers consumers a variety of ways to enjoy content, such as through electronic download, video-on demand, and streaming services. License-based options are designed around flexible access to content, not the acquisition of physical objects. Electronic delivery has increased the value proposition to consumers by enabling access to content virtually anywhere, at any time, to multiple authorized users, and on multiple devices; and this increase is evident in the high rate of user adoption.

The first sale doctrine -- created more than 100 years ago and codified in 1976 -- permits the owner of a physical object containing a work to sell or give away the object. The doctrine addresses limitations inherent in physical objects: they take up space, require the user to maintain possession and expend some effort to transport, impose costs to produce additional units, are often manufactured in limited runs or are otherwise scarce, and typically decay with age. Some are proposing changing the first sale doctrine to apply to non-physical goods. *Doing so is not only unnecessary, it would radically alter the nature and purpose of the doctrine*.

"True north" for any analysis of proposed changes to the Copyright Act should be the maintenance of the central balance that it aims to strike: that is, incentivizing creators to maintain their output of new ideas, and ensuring that consumers have reasonable access to them, irrespective of the particular tools, services or consumer behaviors that may be prevalent at any point. Changing the first sale doctrine to apply to electronically-delivered content would have detrimental effects on that balance. It would do significant harm to creators over time and ultimately hinder the further evolution of flexible, online choices that the content industry currently offers consumers.

For individuals that prefer the traditional ownership model, physical options remain available. But in light of the rapid success of access-based models, it would seem advantageous to let markets continue to drive innovation, rather than intervene and risk the side effects of imposing an old construct on the new, digital landscape.

The Impact of Electronic Delivery

Prior to the emergence of robust, electronic delivery mechanisms, content distribution required that the intellectual property be bound to a physical "host" for transmission to, and access by consumers. For most of the 20th century, *copies* were manufactured on paper, tape or discs, as applicable. In the 1990s, newer content formats were *digital*, but still distributed via physical discs or tapes.

There are a variety of costs (pecuniary and not) to physical distribution that include:

- **MANUFACTURING:** costs associated with producing the host media (e.g., discs, tapes)
- **INVENTORY:** risk associated with producing too many or too few of a particular title
- **DEGRADATION:** decline in the "quality" of the copy over time and with frequent use
- **DISSEMINATION:** need to coordinate shipments across various geographies to match demand; need for a consumer to have possession of physical media in order to access content

Electronically-delivered content became commercially significant in the early 2000s, as increases in available bandwidth made Internet "pipes" wider, and advances in data compression made digital files smaller. Broadly, there are two mechanisms for this kind of distribution: *downloading*, where the user takes a complete instantiation of the content and stores it locally; and *streaming*, where small, sequential portions of the content are transferred for viewing as needed from a service that stores the content remotely.

The elimination of the physical host requirement from the transfer process yielded tremendous efficiencies, and most conventional costs could be greatly reduced, or eliminated outright.

	PHYSICAL DELIVERY	ELECTRONIC DELIVERY
HOST:	paper, disc, tape	none
DEGRADATION:	varies	none
DISTRIBUTION COST:	relatively high	relatively low
DISTRIBUTION "VELOCITY":	low	high

- There is no longer any substantial manufacturing cost or inventory risk.
- As a file stored digitally, the content does not degrade with repeated use or over time.[1]
- Access to the content no longer requires the presence of any specific object. As long as a user is connected to the Internet via an authorized device, he/she may access content for which he/she has rights. Most importantly, the speed with which content can be moved is nearly instantaneous, much faster than any physical host could be exchanged, shared or transferred.

[1] It is the case that the storage medium on which the files sit may degrade over time, but whether stored locally by a consumer, or remotely by a service, these can be easily transferred to newer storage, and again, without any loss of fidelity.

Problems with Creating an On-Line First Sale Doctrine

There are several reasons why creating a first-sale doctrine for electronically-delivered content would disrupt the balance between creator incentives and consumer access. In weighing them, it is important to recall that first-sale ideas were borne out of the inherent limitations of physical distribution. *These factors (particularly degradation and relatively low "velocity" of exchange) made secondary-market (used) content fairly distinct from primary-market (new) versions of the same IP*, such that the two markets could coexist. From inception, the first-sale doctrine relied on these characteristics to achieve its purpose, and this notion is supported by the U.S. Copyright Office, which has confirmed that the particular limitation to physical objects is not a relic of outdated technology but "a defining element of the doctrine and critical to its rationale."[2]

Consumer access is not constrained on the electronic distribution mechanisms that content owners have embraced.

Across a variety of dimensions, content is more accessible than ever.

- **AVAILABILITY:** There are more than 100 legitimate streaming services offering a broad array of film and television content to U.S. consumers. This list includes: Netflix, Hulu, Amazon, VUDU, and HBO GO.[3]
- **ACCESS POINT:** Services (such as those named above) are usable on a wide array of device categories, including desktop and laptop computers, tablets, and smartphones, in addition to televisions.
- **REVENUE MODEL:** The practice of licensing rights, rather than manufacturing copies of content for sale, has enabled distributors to expand available offerings. Film and television can now be obtained via permanent license (EST), temporary license (VOD), or subscription service (SVOD). Recorded music is also widely provided on both permanent license and subscription bases.

And consumers have responded favorably to these offerings. In 2009, U.S. consumers were already accessing 376 million movies and 20 billion TV shows online, according to Screen Digest. By 2013, those numbers were up to 5.7 billion movies and 56 billion TV shows.

So unlike the case with physical media, here there is really no evidence that consumer access is constrained.

The potential velocity of exchange of "pre-owned" licenses is so high that it would be impossible for a creator to set an appropriate price for new works.

First-sale may have been conceived to reduce some potential "friction" inherent in physical media, but it also anticipated that much of it was inevitable and would remain. As noted earlier, the characteristics of paper, tapes, discs, etc. were what allowed both a

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[2] Executive Summary, Digital Millennium Copyright Act Section 104 Report, *available at* http://www.copyright.gov/reports/studies/dmca/dmca_executive.html.

[3] www.wheretowatch.org

primary market and a secondary market to coexist, offering the consumer very different value propositions.

In the physical world, "used" copies are distinct from the original. They are either cheaper because they are no longer new, or more expensive because they are rare. "Used" electronic content, however, is indistinguishable from the original. Consequently, the used market would supplant the original market, depriving creators of a return on their investment and reducing their incentive to create content in the first place.

Electronic distribution turns traditional dynamics on their head, most notably in the way that content is now transferable from one consumer to another. Physical media must be handed off (literally) from *A* to *B*. Therefore:

- *A* and *B* must know one another to communicate, or both must use an intermediary (e.g., a physical storefront) that is willing to take control of the copy between the time that *A* offers the product and *B* wishes to obtain it.
- *B* will then take it away, and *A* will no longer have control, so the nature of the transaction (whether or not it involves an intermediary) will be a permanent sale, rather than a loan, because *A* is unlikely to have recourse when *B* disappears.
- The coordination of multiple buyers and sellers in terms of location, timing and price negotiation is a relatively cumbersome process.

The equivalent mechanism in a realm of electronic licenses is perfectly efficient, so much so that it could have devastating effects on the primary market for like content. In this context, the actual content files are encrypted and are easy to obtain, though difficult to unlock. Licenses to use the content come as separate "key" files that decrypt the content file for playback. Because of this:

- *A* and *B* need not know one another, and the matching by an intermediary could be accomplished by low-cost servers that operate open-source Internet routing software.
- *A* might "sell" the license to *B*, making the transfer relatively permanent, but this is no longer a practical necessity as it was with physical media. The same intermediary could set rules on how long *B* could access the content before the rights reverted, automatically, to *A*. This would enable very short-term "loans" of the content to *B*.

Under this arrangement, one single instantiation of a content license could provide utility to potentially hundreds of users; as long as only one user wanted the content at any given time. If such a mechanism were in place, a rational content owner would anticipate this and price each individual content license based on its capability to serve many, rather than one. But it is highly implausible to expect that a marketplace where film or television content costs 10-100x its "customary" price would find many willing buyers to begin with. The result would be a market failure.

Dr. John Villasenor, a fellow witness in today's hearing, has acknowledged this problem and suggests that, "…a digital first-sale doctrine would need to be structured to ensure that very short-term (e.g., a few minutes), anonymous digital loans are not within the scope of permitted dispositions of copies of works."[4] But addressing this would require the explicit demarcation of short-term and long-term (i.e., permissible) dispositions of these licenses. This would be challenging to analyze appropriately, for legislators and copyright holders alike.

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[4] Villasenor, John, "Rethinking A Digital first-sale Doctrine In A Post-*Kirtsaeng* World: The Case For Caution", *CPI Antitrust Chronicle*, May 2013

Conclusion

Critics might assume that a reluctance to expand first-sale to electronically-delivered goods is a blind defense of old models, but this is wrong. My opposition is based on three critical points of logic:

- First, that the purpose of first-sale – to limit copyright *only* for purposes of easing the inherent "friction" associated with physical media – is simply unnecessary in a world of electronic licensing, where access to the content itself is relatively costless.
- Second, that because of the hyper-efficiency of electronic distribution, there will be no natural "firewall" between the primary and secondary markets for content. This will substantially compromise the most valuable commercial models that are in place today.
- Finally, content owners are currently developing new models to engage modern audiences more deeply, but these will rely on a market that fosters long-term investment by consumers in their favorite franchises. A mechanism that allows this holistic experience to be broken up and disposed to others breaks the model. As a result, producers will inevitably discontinue investment in these products.